



Investment Office

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AGENDA ITEM 6a

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

- I. SUBJECT:** Revision of Directed Brokerage Arrangement
- II. PROGRAM:** Administrative Services and Operations
- III. RECOMMENDATION:** Approve the reading and recommend to the Investment Committee approval of the revised Statement of Investment Policy for Directed Brokerage Arrangement

IV. ANALYSIS:

Staff brings this policy revision forward to address two issues; 1) to acknowledge in Policy, CalPERS' adoption of a narrow definition of directed brokerage, 2) to update and clarify language and align the Policy with current CalPERS practice. This Policy revision also removes the administrative activities from the policy document, acknowledging they belong more appropriately in administrative procedure desk manuals. All administrative controls currently in place will remain in effect.

CalPERS' current and revised Directed Brokerage Arrangement Policy is consistent with the SEC's existing guidelines and proposed Guidance Regarding Client Commission Practices under Section 28(e).¹ The SEC's proposed Guidance aims to clarify the scope of "brokerage and research services" in light

¹ Securities and Exchange Commission Release No. 34-52635; File No. S7-09-05. This proposed interpretation more clearly defines what type of products and services are allowable and disallowable under Section 28(e). Notable changes include as allowable; market, economic and financial data as well as communication/transmission products and services used to execute, clear and settle a transaction. Examples of disallowable products and services include computer hardware, professional licensing fees and general overhead expenses.

of evolving technology and industry practices to help determine if a particular product or service falls within the scope of 28(e).

The proposed policy clarifies the narrow definition of Directed Brokerage Arrangements that CalPERS has adopted. Industry practice for directed brokerage arrangements allows a broker to directly provide services to its clients, directly pay certain of the client's obligations (expense reimbursement) or return a specified portion of commissions to the client. The last is known as commission recapture. CalPERS has chosen to implement commission recapture arrangements only. The clarification in Policy recognizes existing operational procedures that require all recaptured commissions to be returned to CalPERS for safekeeping as well as disbursement to service providers. The result is that all CalPERS funds are held within our custodial relationship, and all eligible portfolio management services, research and analytical tool purchases comply with SEC provisions and are paid using the System's standard procurement process. The result is an efficient and fiscally sound program that is in full compliance with SEC guidelines.

There is gradual industry movement away from directed brokerage arrangements due to advances in high volume trading as well as continued downward pressure on commission costs by buy-side market participants like CalPERS. As oversight by regulatory organizations increases, there are additional constraints placed on the use of recaptured commissions. In addition, CalPERS' movement to external investment strategies that do not generate normal commission spreads and our continued in-sourcing of investment strategies further minimizes the potential for growth in recaptured commissions. The impact of these changes can be seen in CalPERS' decreasing flow of recaptured commissions. CalPERS received \$8.7 million in recaptured commissions during Fiscal Year 04/05 while current year projections are estimated to be only \$3.4 million. However, CalPERS still receives significant benefit from its Directed Brokerage Arrangements and has no current plans to eliminate the program.

Lastly, it is important to note that staff is proactive in the management and oversight of the Directed Broker Arrangements. Directed Brokerage language is included in CalPERS' external investment manager contracts. In addition, staff negotiates with investment managers the percentage of commissions to be directed to brokers participating in the program; confirms that the investment manager's trade execution is not adversely impacted by the use of participating brokers; and provides regular reports to the Board and monitors the investment manager's participation on a monthly basis to ensure compliance with the Policy.

V. STRATEGIC PLAN:

This item is not part of the Strategic Plan, but is part of ongoing workload.

VI. RESULTS/COSTS:

There are no costs associated with the proposed revision.

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